VZCZCXRO1775
RR RUEHLH RUEHPW
DE RUEHIL #0945/01 1231017
ZNR UUUUU ZZH
R 031017Z MAY 09
FM AMEMBASSY ISLAMABAD
TO RUEHC/SECSTATE WASHDC 2554
INFO RHEHNSC/NSC WASHINGTON DC
RUEKJCS/SECDEF WASHINGTON DC
RUEHRC/DEPT OF AGRICULTURE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/DEPT OF COMMERCE WASHDC
RHEBAAA/DEPT OF ENERGY WASHDC
RHMFISS/CDR USCENTCOM MACDILL AFB FL
RUEAIIA/CIA WASHDC
RHEFDIA/DIA WASHINGTON DC
RHMFIUU/FBI WASHINGTON DC
RUEHDO/AMEMBASSY DOHA 1642
RUEHLO/AMEMBASSY LONDON 0236
RUEHML/AMEMBASSY MANILA 3164
RUEHNE/AMEMBASSY NEW DELHI 4836
RUEHBUL/AMEMBASSY KABUL 0216
RUEHLH/AMCONSUL LAHORE 7173
RUEHKP/AMCONSUL KARACHI 1569
RUEHPW/AMCONSUL PESHAWAR 6108

UNCLAS SECTION 01 OF 02 ISLAMABAD 000945

SIPDIS

E.O. 12958: N/A
TAGS: ECON ETRD EAID PGOV PREL PK
SUBJECT: PAKISTAN UNLIKELY TO MEET ALL IMF TARGETS BUT IMF RESREP UNCONCERNED

ISLAMABAD 00000945 001.2 OF 002

¶1. (SBU) Summary: Pakistan is unlikely to meet all its IMF targets, but Islamabad Resident Representative Paul Ross seemed unconcerned. Ross and noted Pakistani economist Dr. Ashfaque Hassan Khan told Econoffs that Pakistan is unlikely to meet its tax collection and fiscal deficit targets. Ross pointed out that fulfillment of pledges from the donors' conference will provide a needed economic stimulus that Pakistan could not otherwise finance, to fund social safety net and development projects. Two areas to watch are the growth in remittances (which may indicate that Pakistanis have lost overseas jobs and are moving home) and decreases in exports. Pakistan's textile exports are down, but overall exports remain at the same level due to healthy increases in agricultural and cement exports. End summary.

¶2. (SBU) In advance of the May IMF review, econ officers met 30 April with IMF Resident Representative Paul Ross and former Ministry of Finance Special Secretary Dr. Ashfaque Hassan Khan regarding their views on Pakistan's ability to meet its IMF targets, including tax revenues, economic growth, monetary growth, the fiscal deficit, and inflation. (Note: Khan recently left government, and is now the Dean of the National University of Science and Technology (NUST) Business School. End note.) Pakistan's reserves continue to increase, and are now at USD 7.8 billion, up from USD 3.5 billion in October 2008. The exchange rate has stabilized at 80 to 81 rupees after a 13.2 percent devaluation between July and November 2008.

Concerns Over Increases in Remittances
- -

¶3. (SBU) Private inflows have slowed but Pakistan will not have a balance of payments deficit this fiscal year, according to Ross. Both economists agreed that despite current macroeconomic stability, the increase in remittances (which may indicate that overseas Pakistani workers are losing their jobs and transferring assets home) and decreases in exports (due to the worldwide economic recession) are two areas to watch. Pakistan's textile exports have decreased by 2.71 percent but overall exports are flat, due to healthy increases in agricultural (29.3 percent increase), cement (102.61 percent increase), and chemicals (12.3 percent increase) exports.

Tax Revenue Target Unlikely to Be Met
- - - - - - - - - - - - - - - - - - - -

¶4. (SBU) Ross and Khan agreed that the GOP is unlikely to meet its annual IMF tax revenue target. The GOP has revised downwards the tax collection target from Rs.1360 billion ($16.90 billion) to Rs.1250 billion (USD15.52 billion), but provincial expenditures are still based on the original target of Rs 1360 billion. Pakistan's tax base is very narrow, with no taxes on agriculture and most services. Ross commented that the GOP is likely to make up the tax revenue shortfalls through the petroleum levy. (Note: Pakistan pump prices are above current international market prices; the government pockets the difference. End note.)

¶5. (SBU) Khan highlighted areas where the government is not collecting tax revenues, including withholding taxes where the government loses Rs. 200-250 billion (USD 2.48 - 3.1 billion) annually after introduction of a self-assessment system without a robust audit system. Khan also criticized the IMF program tax target which increases tax collection from Rs 1250 billion (USD 15.52 billion) to Rs 1360 billion (USD 16.9 billion) when customs revenue was dropping due to an IMF mandate to decrease growth in imports to one percent. Imports grew 23.8 percent in FY 2007-2008. Since tariff collections from imports represent approximately 45 percent of tax receipts, the IMF target is virtually impossible to meet, according to Khan.

Falling Short on the Fiscal Deficit Target, Too
- -

¶6. (SBU) As a result of the anticipated tax collection shortfall, Pakistan will have difficulties reaching its fiscal deficit target

of 4.3 percent, according to Khan. Ross commented that the GOP is making serious efforts to meet its target, and has eliminated fuel subsidies. However, he is concerned that it will be difficult to phase out the electricity subsidies by the June 30 end of the fiscal year. Elimination will require a four percent tariff increase, but a rate increase combined with blackouts has led to serious demonstrations in the past. Ross and Khan agreed that Pakistan should tax agriculture, which accounts for 20 percent of GDP but only one percent of tax revenue. Most farmers pay no income tax. Currently the federal government argues it cannot tax agriculture since the provinces regulate the sector.

But Still Positive Growth - Barely
- - - - - - - - - - - - - - - - - - -

¶7. (SBU) The Ministry of Finance continues to project a 2.5 percent growth rate, based on forecasts for a good harvest and 4.2 percent growth in the service sector. Ross thought that Pakistan would reach two percent growth, which given Pakistan's two percent annual population increase essentially reflects zero growth. Khan projected a one percent or even negative growth rate.

¶8. (SBU) Economic growth has slowed in large part due to tight monetary policy. While the IMF stipulates a 10.8 percent growth for M2 money supply, Khan commented that M2 will only grow by 4.5 percent. With negative net foreign asset inflows, domestic assets cannot grow sufficiently in the absence of borrowing from the State Bank of Pakistan. Despite the tight monetary policy and decreases in international commodity prices, core inflation remains at 17.9 percent. Part of this stickiness is due to the composition of the core inflation index, where housing rental costs (which many Pakistanis do not pay) is a principle component of the index.

Donor Pledges as Economic Stimulus
- - - - - - - - - - - - - - - - - - -

¶9. (SBU) Ross highlighted that fulfillment of the donors' conference pledges will provide an important economic stimulus to the slowing Pakistani economy that the government could not afford to fund on its own and still meet the IMF targets. While the financial inflows are helpful for Pakistan's balance of payments and

reserve buildup, these funds will allow Pakistan to implement social safety net and development programs eliminated to meet its fiscal target.

Comment
- - - -

¶10. (SBU) Comment: Ross and Khan appeared unconcerned about Pakistan's slippages in meeting its IMF fiscal deficit and tax collection targets. Pakistan has taken a number of difficult economic decisions over the past few months - elimination of central bank borrowing and deep cuts in expenditures for social safety net and development programs. As a result, it is important that donors honor their conference commitments to provide Pakistan a needed economic stimulus and broaden the social safety net. However, in order to ensure continued economic growth, Pakistan still needs to make structural reforms, including broadening its tax base and making the energy sector more attractive to investors. End comment.

FEIERSTEIN